Economic Outlook

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The newspapers are full of articles these days about bankruptcies, losses, and earnings declines. With all of the worrisome earnings reports, concerns have been raised that the long-awaited pickup in economic activity will not occur anytime soon. With the past declines in interest rates and the substantial depreciation of the dollar, it seems that the long-awaited acceleration in real GNP growth should not be far off. Moreover, despite the paltry 0.6% annualized rise in real GNP in the second quarter, real GNP has increased 2.5% at an annual rate during the last two years. This is distinctly below normal for a recovery period but only slightly below the economy's 3.0% long-term growth rate. (After a recent major data revision, real GNP growth during 1985 is now estimated to be 0.8% higher than previously indicated.) With the assumption that the real trade balance shows moderate improvement through next year, real GNP is expected to rise 3.6% from the fourth quarter of 1986 to the fourth quarter of 1987.

According to a recent Department of Commerce report, after-tax profits in the second quarter rose 4.1% from the first-quarter level and 11.1% from a year ago. Profits are still 3.8% below the peak level reached in the first quarter of 1984. Despite a sharp rebound in profits during the initial stage of this expansion--a 40.4% gain in the first 15 months--profits have never recovered to the all-time peak reached in the first quarter of 1980. Since the Department of Commerce uses IRS data as the basis for the comprehensive profits data it publishes, the shift to a highly accelerated depreciation schedule in 1981 tended to restrain growth in aggregate profits in government reports on both a before-tax and an after-tax basis. Consequently, the "quality" of profits is actually better than the unadjusted numbers indicate.

The Department of Commerce also provides data on profits adjusted so that inventories used in production are valued at current cost and depreciation is valued at estimated current replacement cost. On this basis, after-tax profits rose 140.2% from the bottom of the last recession to the first quarter of this year, a record gain to a record level, but then fell 3.5% from the first to the second quarter. Despite this favorable assessment of operating profits, companies have lost billions of dollars in this recovery. Important industries are experiencing wrenching adjustments that transcend normal business cycle fluctuations, and their problems will be visible for years to come.

Many corporations have been so attentive to containing costs as reported profits have stagnated that they will benefit dramatically from a pickup in demand. Some companies are already showing the positive effects of dollar depreciation. A potential problem for profits this year is that many firms will have to restate net income because of the pending loss of the investment tax credit retroactive to January 1, 1986, as indicated in the Conference Committee's tax reform proposal. In its budget presented early this year, the Administration estimated the revenue loss due to the use of the investment tax credit by corporations in fiscal year 1986 at $22.3 billion. Although estimates presented in various legislative proposals are significantly less than this amount, the loss of the investment tax credit would mean that the anticipated rise of 8.9% in after-tax profits this year without a change in law will become a 3%-6.5% decline after restatement because of tax reform.

Bernard Schoenfeld

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Economic Forecast

Percent Changes at Annual Rates

	Actual		1986		Forecast 1987				Actual 1984-	Forecast 1985-	Forecast 1986-
	I	II	III	IV	I	II	III	IV	1985	1986	1987
Gross National Product	6.2	3.0	7.3	8.3	8.2	8.5	8.3	7.3	6.2	5.8	7.3
Real GNP	3.8	0.6	3.8	4.2	4.0	4.0	3.8	2.5	2.7	2.8	3.7
GNP Price Deflator	2.5	2.5	3.2	4.0	4.0	4.3	4.4	4.6	3.4	2.9	3.5

	Actual 1986:II	Forecast 1986:III	Actual 1984-1985	Forecast 1985-1986	Forecast 1986-1987
Consumer Spending	5.7%	6.3%	7.1%	6.2%	6.9%
Durable Goods	17.6	2.5	8.5	4.6	6.8
Nondurable Goods	-0.3	4.5	4.0	3.7	6.1
Services	6.7	8.6	8.9	8.2	7.5
Business Capital Spending	-2.3	5.5	10.0	0.7	4.3
Structures	-32.3	-3.9	11.1	-7.6	-2.6
Equipment	16.0	10.0	9.4	4.9	7.4
Residential Investment	21.9	16.5	5.7	13.8	6.9
			1985	1986	1987
Change in Inventories	$12.5b.	$20.0b.	$11.1b.	$25.6b.	$33.3b.
Net Exports of Goods and Services	$-100.2b.	$-108.0b.	$-78.9b.	$-101.6b.	$-90.3b.
			1984-1985	1985-1986	1986-1987
Government Purchases	11.6%	8.6%	11.2%	6.3%	7.4%
Federal	13.4	12.9	13.7	4.9	8.9
Defense	18.6	13.8	10.4	8.2	9.3
Other	-0.9	10.2	24.3	-4.4	7.7
State & Local	10.4	5.5	9.3	7.3	6.3
Corporate Profits Before Tax	8.5*	4.1*	-5.3	5.5	10.1
Corporate Profits After Tax	11.1*	8.7*	-6.4	8.7	10.6
Plant and Equipment Expenditures	-1.0F	3.0	9.0	-2.3	4.0
Real Final Sales#	3.8	3.1	4.2	2.4	3.5
Real Disposable Personal Income	7.4	3.3	2.3	4.1	3.4

Economic Indicators	Recent Data May	June	July	Actual 1984-1985	Forecast 1985-1986	1986-1987
Consumer Price Index**	2.4%	6.0%	n.a.	3.7%	2.5%	4.2%
Producer Price Index for Finished Goods**	7.2	0.0	-4.8%	2.1	-1.3	3.6
Industrial Production	-0.5	-0.3	-0.1	2.2	0.3	2.0
Retail Sales##	0.8	-0.1	0.1	6.4	4.0	6.0
				1985	1986	1987
Auto Sales (millions of units, a.r.)	11.3	11.1	10.7	11.1	10.9	10.3
Housing Starts (millions of units, a.r.)	1.86	1.85	n.a.	1.74	1.88	1.70
Unemployment Rate	7.3%	7.1%	6.9%	7.2%	7.0%	6.5%
Merchandise Trade Deficit (a.r.)	$170.5b.	$170.0b.	n.a.	$148.5b.	$155.0b.	$130.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).
$b. = billions a.r. = annual rate F = Forecast

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